

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

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PLR-119257-06

Date: October 17, 2006

### LEGEND

X =

Date 1 =

Date 2 =

State =

Year =

Dear :

This responds to a letter dated March 29, 2006, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

### FACTS

The information submitted states that X was incorporated on Date 1 in accordance with the laws of State. X elected to be an S corporation effective Date 2. Since X's election to be an S corporation, X has filed composite state income tax returns in certain states on behalf of its eligible shareholders. X has also paid the composite tax due on those returns on behalf of the shareholders. Prior to Year, X received and kept state tax refunds with respect to composite returns, while individual shareholders who did not participate in the composite return kept any refunds even though some of those taxes were initially paid by X. These practices have resulted in X making disproportionate distribution to certain shareholders. X determined that the disproportionate distributions

may have created a second class of stock in violation of the one class of stock requirement of § 1361(b)(1)(D).

X represents that it did not intend to create a second class of stock or to terminate X's S corporation election and that the circumstances resulting in the possible termination of the election were not motivated by tax avoidance or retroactive tax planning. X represents that it has taken the following corrective actions: (1) Corrective distributions were made to affected shareholders so that each shareholder received the correct proportion of distributions for the years at issue based on the weighted average ownership percentages for each year, including interest; (2) Since Year, X has been treating state tax payments made on behalf of shareholders as deemed distributions when determining whether distributions have been made proportionately. The amount of a shareholder's total distribution for a year related to state tax payments is disclosed on each shareholder's Form K-1. X will continue this treatment in future years. X and its shareholders agree to make any adjustments, consistent with the treatment of X as an S corporation, as might be required by the Secretary.

#### LAW AND ANALYSIS

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the "governing provisions"). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1362(d)(2)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business

corporation. Section 1362(d)(2)(B) provides that the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation is a small business corporation, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

## CONCLUSION

Based solely on the information submitted and the representations made, we conclude that X's S corporation election may have terminated because X may have had more than one class of stock. However, we conclude that, if X's S election was terminated, such termination was inadvertent within the meaning of § 1362(f). Therefore, we rule that X will be treated as continuing to be an S corporation from Date 2, and thereafter, provided that X's S election is not otherwise terminated under § 1362(d). X's shareholders, in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately stated computed items of income or loss of X as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by X as provided in § 1368.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed or implied as to whether X otherwise qualifies as an S corporation under § 1361.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Audrey W. Ellis  
Senior Counsel, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

cc: